



*Appropriate Regulatory Treatment Of ILEC
Broadband Facilities And Services*

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November 15, 2002



Central Policy Question

Is There A Continued Need For Wholesale Broadband Access Regulation?

- Carriers -- UNEs
- ISPs -- *Computer Inquiries* Rules

The Need For Access Regulation Turns On Market Power Analysis In The Relevant Markets

- Services/facilities purchased by carriers
 - Broadband transport to provide voice and data
- Services/facilities purchased by ISPs
 - Broadband transport to provide high speed Internet access and value-added services
- **But**, both carriers and ISPs lack effective alternatives to Bell facilities/services.
- The result: the Bells have **market power**

What About Retail Competition?

- **Q:** Is retail competition between cable modem and DSL services the solution?
 - Theory 1: If consumers have retail alternatives, who needs ISPs and competing carriers?
 - Theory 2: Retail competition will provide strong competitive incentives to Bells to accommodate all reasonable access requests
- **A:** No, even assuming ubiquitous retail cable modem alternatives
 - (Of course, cable is not an ubiquitous alternative to DSL, even for residential customers and is generally unavailable to business customers, see California Comments at 28 (“Forty-five percent of Californians that live in cities with broadband service have DSL service as their only broadband option.”); Inc.com (summary of July 2001 McKinsey study) (“More than 80 percent of midsize and small businesses are sufficiently close to a telephone-switching office to subscribe to DSL, whereas cable, having started out as an entertainment medium, reaches fewer than 20 percent of such businesses in the United States.”)).

Retail Competition Is No Solution

- Cable does not today provide the key services that consumers demand and could obtain from competing carriers and ISPs
 - Carriers: Cable generally does not provide voice and high speed data
 - ISPs: Cable generally does not provide the broad choice of ISPs that is available over the Bells' facilities
- Business customers generally have no cable alternative at all

Retail Competition Is No Solution

- The retail competition “solution” ignores the Bells’ skewed incentives
 - Cannibalization of existing high margin data services and second line sales
 - Protection of primary line voice monopolies

The Bells' Skewed Incentives

- The Bells have conceded that lower DSL prices/greater DSL availability cannibalize high margin second line and T1 services.
 - According to BellSouth's economists:
 - [A]dvanced services are increasingly likely to cannibalize the traditional services offered by ILECs. For example, the advent of digital subscriber line ("DSL") technology has applied the brakes on ILECs' "second line" service, and dedicated high-speed connection to packet switches are steadily replacing modem-based connections to switched-circuit networks, while delivering services of equal or better quality to customers.
 - DSL deployment brings a number of additional costs For instance, about 30% of new DSL subscribers give up a second phone line.
- [BellSouth, NERA Reply Report, CC Docket 01-338, ¶ 167; Harris Reply Dec., Att. 2 (DSL Business Case), CC Docket 01-338, at 3.]

The Bells' Skewed Incentives

- Because of this cannibalization effect, the profit-maximizing price for Bell DSL prices will not be the competitive market price.
- The reality is that the Bells do not lose all broadband customers by pricing higher than cable.
- The Bells raised DSL prices by 25% but did not lose all of their broadband customers to cable even though cable did not match the price increase; in fact, DSL customer bases continued to grow.

The Bells' Skewed Incentives

- Broadband and narrowband services are provided over the same wires and, therefore, there are economies of scope and complementarities in production and demand.
- Offering both voice and DSL service over the same ILEC loop may be the best, and perhaps only, means of profitably entering in many areas.
- At a minimum, denying competitive carriers the ability to offer DSL services forecloses competitive carriers from competing for the growing number of customers that demand voice/data services over a single line from a single provider.

The Bells' Skewed Incentives

- There are similar problems on the ISP side.
- Granting ISPs access would risk what the Bells would view as “over-promotion” by some ISPs.
- That in turn could attract even more of the Bells profitable dial-up customers and also deny the Bells the opportunity to sell future value-added services to those customers.
- Tellingly, the Bells have largely withdrawn “transport” only tariffs that allow customers to choose their ISP and have reserved bandwidth for future services in the tariffs governing broadband transport for ISPs.

There Are No Policy Reasons To Deregulate The Bells' Notwithstanding Their Enduring Market Power

- *Regulatory Parity* -- Common economic principles yield different answers due to voice monopoly and cannibalization concerns that are unique to the Bells
- *Broadband Investment* -- Both economic theory and empirical analysis confirm that wholesale access regulation stimulates both competition and investment (by CLECs and ILECs)

Retail Regulation -- Small Business

- The Bells dominate the provision of broadband services to small businesses.
- That is because cable is not generally available in business districts; existing “small business” customers are primarily businesses in suburban areas and businesses that purchase cable modem services for employees that telecommute.
- “More to the point, the ‘race’ for subscribers may be a red herring. If we look at the future and focus on the race for profits rather than warm bodies, DSL providers appear to occupy the stronger position in the highly profitable midsize and small-business segment than does cable, because of the latter’s origins as a conduit for pay television. . . . More than 80 percent of midsize and small businesses are sufficiently close to a telephone-switching office to subscribe to DSL, whereas cable, having started out as an entertainment medium, reaches fewer than 20 percent of such businesses in the United States.” [Inc.com (summarizing July 2001 McKinsey study)]

Retail Regulation -- Small Business

- Perhaps the best evidence that DSL generally does not face facilities-based competition for small businesses is Bell pricing -- the same or similar broadband services provided to businesses are more expensive than DSL services to customers
 - “T1 and fractional T1 continue to prosper. ILEC salesforces are motivated to sell T1 first and DSL second. . . . The ILECs have done very little to push DSL to small businesses.” [Yankee Report (August 2002)]
 - “Even though business subscribers only represent 23% of the total DSL subscribers, they comprise 56% of all DSL revenues in the US On average a business customer’s DSL service will amount to a \$200.00 charge monthly.” [2002 In-Stat Report]

Retail Regulation -- Large Business

- To provide ATM and Frame Relay to large businesses, a carrier needs access to high capacity loops and transport. In most locations, the Bells are the only suppliers of these local facilities today, and duplication of these network facilities is not economically feasible.
- The Commission has largely deregulated the Bells' prices for these inputs and the result have been monopoly charges.
 - Bell annual returns on special access are now as high as 50%
 - Special access rates are more than twice TELRIC
- The Bells have both the incentive and ability to implement a price squeeze

Retail Regulation -- Large Business

- Where the Bells have been allowed to provide ATM and Frame Relay (within LATAs), they have dominated with a 90% share.
 - Competition is not possible where the Bells' charge competitors special access rates that are well in excess of costs, and in some cases in excess of retail prices
- The Bells will also be able to price squeeze long distance competitors once they gain interLATA authority
 - "SBC's growth in business long-distance services continues to be strong. In the third quarter, business interLATA revenues in the five Southwestern Bell states grew more than 30 percent year over year, and interLATA revenues for medium- and large-business customers increased more than 80 percent sequentially from the second quarter this year, the company's largest sequential growth category to date." [SBC 3rd Quarter Report at 5 (2001)]
 - "We also have significant enterprise market opportunity that will fully open up when we get complete 271 authorizations in all states. However, we are not waiting to develop these opportunities in states where we are permitted to provide LD services today. We have had several contract wins and are gaining traction with wins for interLATA data services on either a statewide or regional basis, where we have 271 relief, and we have [a] very active pipeline of bids as well. . . . [Y]ou will be hearing more from us on how we plan to more actively address opportunities to gain market share in the enterprise business phase." [Verizon 3rd Quarter Earnings Conference Call Webcast]

